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There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of the voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

Ludwig von Mises, *Human Action*, *A Treatise of Economics*,
Yale University Press, 1949

DELUSION AND ILLUSION

Contrary to the optimistic recovery forecasts, the U.S. economy remains as stubbornly soft as Wall Street analysts and the public remain stubbornly bullish. Their one great hope is that the consumer, animated by an endless rise in house prices, unlimited availability of credit and new tax cuts, will continue to spend beyond his current income until strong business investment kicks in. Though too much debt is obviously one of the U.S. economy's main problems, policymakers and economists plead for more and more debt to prevent the economy from slipping into the inevitable abyss.

While policymakers and economists in Europe and Asia communicate honestly to their public and the markets that their economies are in trouble, American policymakers and economists remain in flat denial of the great troubles in their own economy. We guess that this has two main reasons. The one is a general poor understanding of the structural micro and macro impediments to economic and financial revival; and the other one is general great faith in the efficacy of monetary and fiscal stimulus to produce desired economic growth. It happens that the rest of the world does not share such faith.

Indeed, never before have policymakers endeavored so frantically to instill confidence into hearts and money into pockets. Continuous record growth in money and credit, the 13th rate cut by the Fed, the third big Bush tax cut, continuous records in mortgage refinancing and a falling dollar are definitely adding up to the greatest economic and financial stimulus that the world has ever seen.

By the way, persistent disappointment with the economic effects of Keynesian deficit spending led governments and economists to write it off many years ago as an instrument to resurrect economic growth. Yet hopes are riding high again that the new fiscal stimulus will not fail to spark a strong economic recovery in the United States.

Assessing the U.S. economy's prospects, the first thing to realize is that its recent growth has been considerably weaker than expected and generally trumpeted. Though the second half of the year has commenced, the hard economic data so far are not showing any meaningful acceleration in economic activity, neither in consumer spending nor in business capital investment.

In other words, the stock market's run-up during the last few months has its one and only source in optimistic forecasts and expectations of what the U.S. economy will do in the second half of this year in response to the new monetary and fiscal stimulus.

Is the new package of demand stimulus really of such overwhelming size to justify the rampant optimism in the markets? In our view, it pales in comparison to what has already happened in monetary and fiscal policy. Instead of 12 earlier interest rate cuts totaling 5.5 percentage points, there has been just one of .25%. Why should this 13th cut in a row be the magic that finally lights the fire under the economy?

Or take the new fiscal stimulus. According to the latest official estimates, the federal deficit will rise to \$455 billion this year, up from \$257 billion last year. Most probably, it will be much higher. But the thing to

see is that in the last few years the Bush administration has presided over the most abrupt and rapid turnaround in federal finances for decades. The reversal from a $295.9 billion surplus in 2000 into a $257.5 billion deficit in 2002, equal to more than 5% of GDP, represents the biggest fiscal stimulus in the whole postwar period. Even if the 2003 deficit runs up to $500 billion and higher, as we assume, the *additional* fiscal stimulus will be hardly higher than in the past few years.

What many people flatly ignore in the U.S. case is that it has needed outrageously large injections of new money and credit just for lackluster economic growth that plainly fails to develop self-sustaining thrust. In 2002, total credit growth of $2.3 trillion compared with nominal GDP growth of $375.3 billion. In the end, somebody will have to service these debts.

THE GREATEST POLICY FAILURE

Apparently Fed Chairman Alan Greenspan is still enjoying great admiration for having successfully avoided a longer and deeper recession. We see, instead, a preposterous and frightening discrepancy between most prodigious monetary and fiscal measures to stimulate the economy and their extremely poor effects on the economy. Consider that consumer borrowing surged last year by $768 billion on top of an increase in disposable income — bolstered by tax cuts — of $422.3 billion. And what happened to consumer spending? It increased by $316.7 billion in nominal terms and by $198.8 billion in real terms.

In the first quarter of 2003, additional consumer borrowing by $849 billion compared with additional consumer spending of $315 billion, both numbers at annual rate. Business borrowing increased by $263.4 billion, while business fixed investment fell by $60 billion, both numbers also at annual rate.

Plainly, monetary and fiscal policies in the United States have been of an earned generosity that is unprecedented in history. All inhibitions that formerly used to set some limits to their implementation have been swept away. But looking for its effects, we note an extremely unbalanced result.

Record-sized monetary and fiscal stimulus in conjunction with permanent bullish oratory were highly successful in two ways: *first*, in creating false optimism among consumers and stock investors; and *second*, in stoking ever-more aggressive and extensive financial speculation. Actually, it created new, unsustainable excesses. But it has completely failed in its most important task and objective — that is, in sparking a rebound in business fixed investment. Insider selling of stock, actually, remains at record-high levels.

Historically, periods of recession and slow economic growth have been times in which consumers and businesses retrench, forced by tight money and credit imposed by central banks. The fact that the present global economic downturn started and developed in the face of generally very loose money invariably suggests that it must have other causes than usual.

This economic downturn differs from all its precedents in the postwar period in that it is globally synchronized. Insofar, all countries are in the same boat. But American policymakers stand out as the ones who responded to the economic downturn with unparalleled and unprecedented activism, in particular in monetary policy.

Obviously keen to prevent any painful retrenchment, Mr. Greenspan opened the money spigots wider than ever before in history. His success in preventing a sharper slowdown in consumer spending is obvious. By slashing the Fed's short-term rate with unusual speed far below prevailing long-term rates and announcing his intention to keep it there, he established a very steep yield curve that cried for a massive, heavily leveraged carry trade in bonds. Given America's grossly oversized financial system, it quickly turned into a bond bubble of astronomic size.

With the prolonged persistence of the steep yield curve and his promise to be slow in raising the federal funds rate, he became, intentionally or not, the great creator of three interrelated new bubbles — in Treasuries and corporate bonds, in house prices and in mortgage refinancing, in combination enabling the consumer to maintain his borrowing and spending excesses. Steven Roach of Morgan Stanley called him a *"serial bubble blower."*

We keep reading that economic news has lately improved. Nonsense. Looking at economic data, we distinguish between two different kinds: *hard data*, directly related to economic activity, such as figures for production and new orders, and *artificial data* that are derived from indexes and surveys, widely regarded as early indicators. Any apparent improvements have been exclusively in these heavily opinion-laden indexes that we regard as rubbish.

Ultimately, all questions about a sufficiently robust U.S. economic rebound boil down to one single question: whether this will jump-start business fixed investment. Consumer spending, bolstered by the house-price and bond bubble, has so far prevented the economy's relapse into recession, but it completely lacks the necessary thrust for a sustained and self-reinforcing recovery.

Putting it briefly and bluntly, the U.S. economy's recovery will be investment-led or it will be a non-starter. This letter scrutinizes this problem and gives an answer that we regard as compelling.

BADLY FLAWED COMPARISONS

The whole world economy is in trouble. Yet there are major and minor differences between countries. American policymakers and economists like to boast that the U.S. economy's growth, though also pretty weak, compares very favorably with that of most other countries, the euro zone and Japan in particular.

The most popular measure of the U.S. economy's superior growth performance is its persistently higher real GDP growth rates, measured in chained dollars. Ironically or oddly, all statistical tables containing chained dollars published by the Bureau of Economic Analysis carry a plainly visible note: *Caution on the use of chained-dollar NIPA estimates.* We have always taken this advice to heart.

For many years we have emphasized that America's real GDP numbers, compared to those of other countries, are heavily tilted to the upside through repeated downward revisions in the price indexes. Obsessed with the idea that inflation rates are overstated, American policymakers, Mr. Greenspan in particular, have exerted heavy pressure on the government's statisticians to produce lower ones. They did.

As he attested in a congressional testimony on June 10, 1998, Mr. Greenspan had still another specific reason for wanting lower inflation rates: *"The essential precondition for the emergence and persistence of this virtuous circle is arguably the decline in the rate of inflation to near price stability"* — which, by way of allowing lower interest rates, provides the precondition for a stock market boom.

The last and most ambitious revision of the consumer price index (CPI) occurred in 1998. According to official estimates, it reduced the index by two-thirds of a percentage point. But including earlier changes, the adjustments have been well over one percentage point.

The official explanation and motivation of the adjustments was the declared intention to capture an existing *quality bias* and a *substitution bias*. The quality bias refers to quality improvements in the items that the consumer purchases, being translated into price reductions. The substitution bias tries to capture the reaction of the consumer to price increases by switching his purchases from a more expensive product to a cheaper product. For example, if the cost of beef goes up, the consumer buys less expensive chicken.

In the view of American statisticians, they have developed a greatly improved *dynamic* price index, in contrast to the former stupid, *static* price index. For sure, the new dynamic measuring offers enormous flexibility.

Not included in this most recent revision of the CPI are the substantial GDP growth effects that have in the past few years arisen from the application of hedonic pricing for business spending on computers, capturing increases in computational power (MIPS) or memory storage (BITS), and dating already from 1986.

In the nominal GDP account, measuring all expenditures in current dollars, this item of business spending edged up from $64.6 billion to $76.3 billion between 1995 and 2003. However, in the real dollar accounts — which is the GDP data that everybody focuses on — the application of the hedonic deflator transformed this minimal increase of just $11.7 billion into one of more than 20 times that amount: $269.9 billion, rising from $49.2 billion to $319.1 billion. Actually, this was the main part of the phony investment boom.

STATISTICAL WIZARDRY

But there is something else that grossly distorts comparisons between America and other countries. It results from the American practice to annualize many quarterly figures, the GDP figures in particular. On July 11 we read, for example, in the *International Herald Tribune* that Europe's currency fell after the European Union's executive branch in Brussels said the region's economy would expand no more than 0.4% in the second and third quarters, comparing miserably with the 1.4% recorded in the first quarter for the U.S. economy.

In actual fact, there is very little difference between economic growth in the euro zone and the United States. On closer look, we even presume that U.S. economic growth is recently even lagging that of the euro zone. The U.S. numbers for the first quarter were particularly intriguing.

Widely known about U.S. economic real GDP growth in the first quarter of 2003 is but one single figure, the reported 1.4% rate of real GDP growth — annualized, to be sure. In other countries, as explained, the reading would be 0.35%. That is the first point to see.

Assessing that figure, though, two intriguing statistical effects ought to be taken into account. In chained dollars, U.S. real GDP grew $44.7 billion. The single biggest contributor, with $33.7 billion, was consumer spending. But this was largely offset by lower business investment.

Now to the two intriguing items behind this reported real GDP growth:

The second-biggest contributor was a sharp decline in the U.S. trade deficit, measured in chained dollars. While the U.S. trade deficit effectively increased during the quarter by $11.2 billion to $487.2 billion, it did the exact opposite in the national income and product accounts (NIPA), measuring real GDP growth in chained dollars. Here, the deficit decreased by $25.3 billion to $506.9 billion.

The manifest cause of the divergence is that the measurement in chained dollars implicitly assumes sharply rising import prices away. In this way, the actual increase of the trade deficit in current dollars mutated into a substantial surplus in real terms. This stroke of the pen actually accounted for more than half of America's real GDP growth in the quarter.

The third-biggest contributor to America's real GDP growth in the first quarter of 2003 is the old acquaintance to this letter: hedonic pricing of computers. Measured in current dollars, business spending on computers barely inched up by a mere $0.8 billion to $76.2 billion, at annual rate. But hedonic pricing turned this bagatelle into a major increase by $15.3 billion to $318.5 billion.

This, by the way, is the true source of the widely trumpeted recovery in business investment. The dismal reality in plain dollars is that investment spending of businesses on equipment and software fell against the prior quarter from $863 billion to $848 billion.

Producing together $40.6 billion chained dollars that nobody paid and nobody received, the two statistical adjustments effectively provided 90% of U.S. real GDP growth in the first quarter, reported as $44.7 billion chained dollars.

What's more, to appreciate the grossly imbalanced growth in the first quarter, one must look beneath the aggregate GDP figures. On balance, there was really more weakness than strength. Applying the usual annualized numbers, we saw the following dismal picture: Durable goods consumption contracted at a 1.8% pace, while spending on nondurables expanded at a 6.2% rate and on services at a 0.7% rate. Gross private investment contracted 3.3%, with nonresidential fixed investment down 4.9%. Investment in equipment and software shrank at a 6.5% annualized rate, whereas residential investment surged 10.6%.

The first quarter's GDP price deflator accelerated to 2.5%, exceeding 2% for the first time in six quarters. By category, prices of durable goods declined at a 3.7% annualized rate, while prices of nondurable goods advanced by 4.6% and of services by 3.1%. Import prices surged at an 11.8% growth rate.

Considering all these details about U.S. first-quarter growth and America's particular revisions of the

price indexes, we conclude that current U.S. real GDP growth is in reality negative. There is, in fact, a highly plausible and also striking proof for this shocking assumption. That is America's dismal employment record. The job losses since early March 2001 amount to 3 million. In the euro zone, by comparison, unemployment during this time rose by 1.3 million. Europe had a higher level of unemployment to start with, but its current rise is well below that in the United States.

It was the primary purpose of the downward revisions in America's consumer price index to lower government spending on Social Security benefits to the elderly, indexed to the CPI. But incidentally, it had still another effect that is never mentioned: Statistically, it has marvelously boosted real GDP and productivity growth.

With nominal GDP growth given, any statistical lowering of the inflation rate implicitly creates an exactly commensurate gain in real output, as captured in real GDP. In turn, the entire consequent rise in measured real output is, by definition, attributed to improving productivity, being simply the increase in total output divided by the increase in total hours worked to create that output.

A lowering of the measured inflation rate by just 1 percentage point per year does not appear to be a big deal from an economic vantage point. But in relation to real GDP growth rates of 3–4% per year and productivity growth of around 2% per year, it makes all the difference between a stellar and a mediocre performance. In this light, the small statistical difference was enough to create the fata morgana of an American growth and productivity miracle.

Whatever merits these changes in the measurement of U.S. inflation rates may have had from a purely statistical perspective, there can be no question that the inherent additions to real GDP and productivity growth crucially contributed to the developing euphoria about the wonders of a new U.S. paradigm economy.

WHAT MAKES A TRUE RECOVERY?

America's forecasters are trumpeting that the economy's final recovery from lackluster growth is definitely at hand, predicting for the second half of the year a real GDP growth rate of 3.5–4%, annualized. The common great hope is that better corporate earnings will spark the fervently desired and badly needed business investment recovery.

Mulling over this forecast, we first of all asked ourselves what cyclical recoveries in the past have looked like as to strength and pattern.

The great irony about the current optimistic forecasts for the second half of 2003 is that they grossly lag the growth rates that were common to past cyclical upswings from recessions. The real GDP growth rate of all postwar recoveries averaged 5.3% in their first year and 5.8% in their second year. Annualized quarterly growth rates were between 5–10%. This compares with an annualized growth of 3.5–4% predicted for the current half of 2003. Take the annualization away, and it means real GDP growth of only 1.75–2%.

As to the pattern of past cycles, we made another interesting and most important discovery. Whenever the Federal Reserve eased, spending in the economy shot up across all demand components.

In 1976, for example, the rate of real GDP growth soared from –0.4% in the year before to 5.6%. Within the aggregate, the share of consumption surged from 1.33 to 3.67 percentage points, while gross domestic investment swung as a share of GDP growth from –2.98 to +2.84 percentage points. Business investment, plainly, was the crucial swing component.

In 1983, real GDP growth soared by 4.3%, after –2% in the year before. Consumer spending surged as a share of total growth from 0.76 to 3.49 percentage points and gross private domestic investment from –2.54 to +1.48 percentage points. Government spending, by the way, always played a negligible role.

The obvious lesson to draw is that an economic rebound with the necessary strength to pull the economy towards 3–4% real GDP growth again needs contributions from every single demand component: consumer spending on durable goods, nondurable goods and services; and business fixed investment, inventories and residential building.

In other words, to have a solid and sustained recovery, the economy's engine has to fire on all cylinders. But that is the most improbable thing to happen this time. Because consumer and residential expenditures have kept rising during the overall downturn, there is very little or no pent-up demand at all on their part. If long-term rates do not fall again, the two demand components may even contract.

Trying to maintain some appearance of a superior U.S. economic performance, Mr. Greenspan never tires of emphasizing the sustained productivity miracle. For reasons explained, we have always regarded it as another statistical hoax. There is, in any case, no economic merit in rapid productivity growth that only shows in rising unemployment.

It is a typical mantra of most American economists that productivity growth is the most important factor about economic well-being. In actual fact, it is a statistical number, no more. Whether or not it raises living standards and also creates employment and profits depends completely on the way it comes about.

As a rule, it comes about by putting more machinery behind every worker. In short, capital investment is paramount. It is decisive in boosting recorded productivity growth. But most importantly, it creates, first of all, demand and employment while the capital goods are produced, and secondly, it adds to capacity when the produced capital goods are installed.

Economically, it is in reality all about capital investment, not about a statistical aggregate, conventionally called productivity. For these reasons, the old economists focused exclusively on capital investment, rarely mentioning productivity.

WAITING FOR GODOT

Now to America's predicted and expected recovery in this year's second half. Pointing to the various statistical adjustments in the price indexes that substantially boost America's real GDP growth, we have argued that the reported U.S. growth rates grossly overstate the reality in comparison to other countries. In reality, the U.S. economy is in recession, as reflected in the dismal employment performance.

Of course, it is nevertheless always possible that the economy is embarking on a strong, solid recovery, as predicted and widely expected. The bullish consensus draws its optimistic assessment largely from the belief that a sufficiently strong policy stimulus is now in place and partly from some better-looking indicators.

As to the first assumption about policy stimulus, we can only express our utter amazement. It flatly ignores the extremely poor economic effects of the even more prodigious monetary and fiscal stimulus of the past two-and-a-half years. To us, this recent experience really forbids any optimism in this respect about the future.

Assessing the U.S. economy's prospects essentially begins with two crucial questions: *first*, will businesses start hiring and investing again pretty soon? And *second*, will the consumer be willing and able to keep up his borrowing and spending binge? Please consider that one month of the second half of the year is already behind us.

ANOTHER RECOVERY MIRAGE

Looking for the recovery, it strikes us in the first place that the second quarter was no better than the first quarter, if not weaker. Production posted gains of 0.1% in May and June. But it decreased at an annual rate of 3.2% in comparison to the first quarter.

The central assumption behind the consensus' U.S. recovery forecasts is an incipient, strong revival in business capital spending. In actual fact, it is absolutely indispensable that it materializes very quickly.

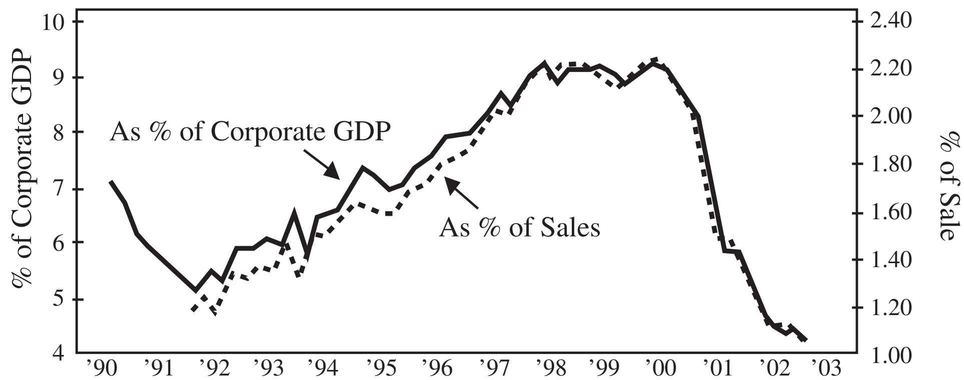
Since any sign of higher investment spending or even of higher production is so far completely missing, we have to look for early indicators. There are modest improvements in survey indexes, generally considered as leading indicators, but there is no trace of it in the hard data, reflecting current facts.

Capital goods orders and shipments, in our view the best proxy for investment spending, remain stuck in virtual stagnation. In fact, "core" orders for capital goods excluding defense and aircraft have dropped 0.4% in

May following a 2.8% decline in the month before. New orders for machinery were 4.3% below their level a year ago, and among them orders for computers and electronic products were down by 9.6%.

However, the bullish consensus argues that the necessary conditions for the investment revival — above all higher profits, higher cash flow and stronger balance sheets — are developing.

Net Investment* by the U.S. Corporate Sector as % of Corporate GDP and Sales



*fixed investment spend less depreciation

MORE PROFIT MALAISE

It is generally agreed that a strong rebound in profits is the key condition for a solid and sustained investment recovery. Aggregate after-tax profits of nonfinancial corporate business, as measured by NIPA, were $197 billion in 2002, even lower than the $205.3 billion in the recession year before. Yet they improved in the course of the year. But as it is so often, the devil is in the detail.

The fact is that profits have been and continue to be heavily inflated by special factors. We note: *first*, big "inventory profits" deriving from rising oil and commodity prices; *second*, big gains from financial activity and speculation; *third*, big currency gains by foreign subsidiaries of U.S. firms; *fourth*, an unusually large rise in the profits of foreign firms in the United States; and *fifth*, continuous, heavy underfunding of pension fund obligations.

If the poor profit performance needs any further proof, it is in the unfaltering "earnings-management game." Despite the condemnation of past accounting tricks, the familiar tricks to make profit numbers look better than they are have remained in rampant use. The one is to report fictive "pro forma" profits, and the other one is to measure them against deliberately reduced "expected" profit. For example: The reported profits of Apple Computer topped expected profits by a whopping 67%. In actual fact, they had fallen 41%.

Whenever we read of better-than-expected profits, we presume cheating. It penetratingly stinks as a systematic delusion of investors, but nobody protests because everybody wants this delusion in the hope that it boosts stock prices. Economic reality is too unpleasant to be faced with open eyes. For people with some common sense, this way of comparison is completely arbitrary and meaningless.

It seems, of course, a fair assumption that a solid second-half economic recovery will not fail to buoy profits. First of all, we do not believe in this recovery, and second, we fail to see the micro and macro adjustments that are necessary to improve profits.

As we have stressed many times, our own assessment of profit prospects is strictly determined by focusing on the particular flows of business revenues and expenses that generate business profits. Based on this analysis, we see nothing that speaks for substantially higher profits. There is a great risk to profits in a probable, prolonged rise in personal saving from current income. A possible boost may come from the rising budget deficit.

AND ALSO WEAK BALANCE SHEETS

But poor profit prospects are not the only reason for our inability to see a solid, sustained investment recovery in the United States. General financial viability, measured by various financial indicators, is another

indispensable condition. How robust are American company finances? The short answer is that balance sheets are not a picture of health. And what's more, it is arguable whether they are improving at all or deteriorating. We believe in the latter. At best, there is very little improvement.

In the frantic pursuit of higher stock prices, American managers in the past few years have systematically devastated the balance sheets of their companies. Financial damage that took several years to build up is not corrected in several quarters.

This devastation of balance sheets took place both on the asset and the liabilities side, essentially with highly negative consequences for future profits. The crucial facts are the following: Since 1996, the capital stock of U.S. corporations in equipment and software has risen by a mere $705.2 billion, from $2,5152 billion to $3,220.4 billion. At the same time, corporate holdings of financial assets soared by $4,566.2 billion, from $5,457.7 billion to $10,023.9 billion.

You can only wonder whether these are still production or finance companies. By far the single biggest item among the bulging financial assets was a ballooning sum of "goodwill," being the ill-famed byproduct of the merger and acquisition mania. As acquiring firms regularly paid prices vastly in excess of book values, they capitalized the difference and put it into their balance sheets as "goodwill." Never mind that these trillions of dollars yielded nil return.

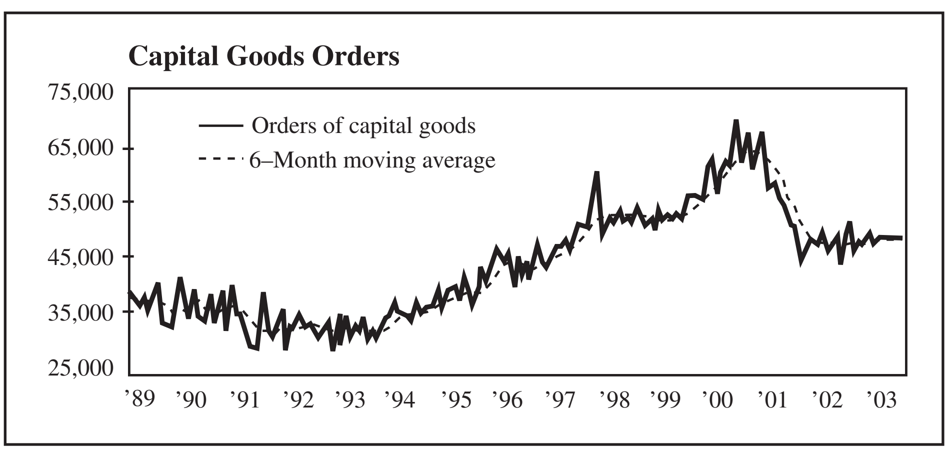
Altogether, this was plainly flagrant, massive malinvestment that had its costly counterpart in a steep rise in corporate indebtedness by $3,845.5 billion, or 60%, from $6,346.9 billion to $10,192.4 billion. Comparing these debt numbers with the poor equity software numbers, it seems fair to speak of systematic financial suicide.

In principal, there are three different ways to strengthen weakened corporate balance sheets. Two of them are sound; one is unsound. The sound ones are higher retained profits and the conversion of debt into equity through stock issuance; the unsound way is to curtail investment spending and to sack labor, implicitly leaving the liabilities side untouched.

In the United States, the two sound devices to strengthen balance sheets — higher retained earnings and equity issuance — remain completely missing. Corporate debt is not at all down. Though its pace of growth has sharply slowed from its insane earlier pace, it keeps growing at a pace that is unusually high for the economy's slow growth, still running at an annual rate of about $250 billion.

Hoping to slow the debt growth, corporations are massacring the asset side of their balance sheets by slashing their capital investment. Net physical investment growth in the nonfinancial sector has plunged from its peak of $376 billion in 2000 to $32.9 billion in the first quarter of 2003, or around $156.8 billion at annual rate. But it is a gross mistake to believe that this creates liquidity. By reducing in the same vein overall business revenues, it spreads illiquidity.

It is widely argued that rising corporate cash flow will support higher investment spending. Again, we wonder what others see that we do not. The most unusual truth about U.S. corporate finances rather is that retained earnings slumped more than a year ago into negative territory as rising dividend payments have overtaken retained earnings.



As depreciation charges, the other component of business cash flow, are doing little better than stagnate, available internal funds since late 2001 are in a distinct decline. Instead of improving, corporate finances are deteriorating.

After two years of a sharp decline in investment spending, new equipment is likely to be needed simply due to rapid obsolescence of high-tech equipment. But what matters for economic growth and profit creation is net investment measured by gross fixed investment less depreciation charges. It is at a low rarely seen before.

It is argued that the plunge in capital spending represents a positive adjustment for the U.S. economy by reducing excess capacity. We would say that by forestalling the economy's recovery, it prolongs its sluggishness in the first place. It is hard to see a recovery in investment spending without a major improvement in profits. But it is equally hard to see how profits can improve without a strong increase of investment.

INVESTMENT BOOM VS. CONSUMPTION BOOM

In its July 15 report to Congress, the Fed admitted that the economy's performance during the first half of the year had been lackluster and also that there is no hard evidence yet of a stronger economic recovery firmly taking root. It cited as causes the uncertainty over the Iraq war, rising energy prices, lingering aftereffects from last year's accounting scandals and an excessively cautionary mood on the part of business in general. Not surprisingly, it expressed its belief that the new monetary and fiscal stimulus will not fail to restore economic growth.

If Mr. Greenspan and his crew truly regard these flimsy matters as the main obstacles to the U.S. economy's revival, they don't have a clue about the powerful forces that are impeding the return to normal growth. The forces truly depressing the U.S. economy are numerous and deep-seated: an unprecedented profits crisis, badly ravaged balance sheets, excessive financial leverage everywhere, huge malinvestments, grossly inflated asset values, a collapse of saving, a deluge of credit but shrinking cash flow.

The U.S. economy is effectively out of balance as never before. Such imbalances always have the same cause: credit excesses that fueled spending excesses. It has been recognized that America's key problem is the protracted weakness of capital investment. But its cause and its removal are, of course, the key question.

It is the commonly held view that its main cause is a vast excess of manufacturing capacities owing to the investment boom that raged during the bubble years. We have never bought this argument. It belongs to the many gross fallacies in the U.S. economy's assessment. What went to blatant excess in the United States during the past few years was consumer spending, not investment spending.

Traditionally, the United States has a high-consumption, low-saving and low-investment economy. From the perspective of long-term growth, these are definitely negative features. The fact about America's bubble years from 1995–2000 is that all three components have deteriorated. Consumption rose sharply as a share of GDP, while saving virtually collapsed.

This perception of a past investment boom has arisen from the fact that the official statistics for this period indeed showed a steep rise of nonresidential fixed investment, measured in chained dollars, by $506.7 billion, or 62%, beating with this growth even Japan's bubble boom in the late 1980s.

But this calculation has two major peculiarities. Fully one-third of that amount — $170 billion — came from the hedonic pricing of computers, creating dollars that nobody pays and nobody receives. And the other peculiarity is the sharply accelerating depreciations, reflecting a massive shift in business fixed investment towards short-lived high-tech investment.

More than half of the recorded increase in gross fixed investment — $236.6 billion in current dollars — during those five years went through accelerating depreciations for the replacement of obsolete plant and equipment. What matters for capacity creation is net investment, the component that alone adds to the economy's capital stock. It rose between 1991–1997, but from an abysmally low level.

Speaking of the necessary conditions for higher investment spending, it is customary to focus on profits. But in reality, there are two other indispensable conditions: available financial resources that are necessary to finance it and real resources that are necessary to produce the capital goods for the capital investment. For the old economists, both became essentially available through saving from current income.

In an economy where Mr. Greenspan rules over the financial system, the financial side of saving is no

longer a problem. During the past few years, he has ridded the U.S. economy of any monetary restraint. He has made it plain enough that he is not only ready but even eager to make unlimited credit available for whatever purpose of borrowing. In essence, it means that old-fashioned savings have become superfluous.

National savings, already close to zero, will soon enter negative territory. Yet no policymaker and very few economists express any concern. Does it matter? We vividly remember the lively public discussion about the crowding out of business investment through the surging budget deficits at the time of Reaganomics. In fact, business fixed investment in the 1980s was at its weakest in the whole postwar period.

It was thought that such crowding-out of investment implicitly takes place through rising interest rates caused by higher government borrowing. But this rise in interest rates will occur only in a world where the central banks keep the supply of credit somehow limited. Mr. Greenspan is the genius among central bankers who tries to combine unfettered credit expansion with falling and record-low interest rates.

But saving in its proper sense of current income not spent for consumption has another all-important function in the economic growth process of which today's economists have totally lost sight. That is its impact on the allocation of resources in the economy between consumption and investment.

Economist John Maynard Keynes put it succinctly: *"For enterprises to expand their production facilities, two different conditions must be fulfilled. There must be an expectation of profit, and it must be possible to obtain command of sufficient* ***financial*** *and real resources to put the projects into execution."* In short, it needs saving to make investment possible.

THE GREAT SWITCH TO EXCESS

From a structural vantage point, the U.S. economy's recovery from the recession in 1991 actually looked very promising up to 1996. Fixed nonresidential investment during these five years rose by 47.4% and consumer spending by 39%. It accounted for 68% of real GDP growth, gross private domestic investment for 36%. Profits skyrocketed by 86%. As to available savings, a decline in personal saving was offset by sharply higher business saving in the form of undistributed profits. Total debts of the nonfinancial sector grew by 27.5%, or 5.5% per year. However, there were many complaints that annual real GDP growth, averaging 2.8%, was too slow.

It was a very solid pattern of economic growth. But this pattern was to change dramatically for the worse after 1997. Focusing on the skyrocketing stock market, suddenly higher GDP and productivity numbers and euphoric profits forecasts, the bullish consensus began to rave of a new paradigm U.S. economy, accomplishing wonders of profitability and productivity, nobody more so than Mr. Greenspan.

For the bullish consensus, all these miraculous achievements essentially implied an investment boom. In truth, it was a bubble economy in which huge pseudo-wealth creation through the stock market propelled the greatest consumer borrowing and spending of all times. High-tech euphoria was crucial in rationalizing the extraordinary bull run of the stock market and the associated wealth euphoria, but did not cause itself the boom.

From the macro perspective, the three new paradigm years were an outright disaster for the U.S. economy. The decisive negative feature during these years was the drastic reversal in the resource allocation between consumption and investment.

Consumer spending, accelerating in real terms to an annual growth rate of 4.9%, persistently exceeded current output and income growth. As a share of GDP growth, it surged from 68% in the first half of the 1990s to 80%. It is a matter of simple logic that economic growth driven by consumer and government borrowing intrinsically leads to lower savings, lower investments and currency weakness though a rising trade deficit. This was ill-structured economic growth in the extreme.

AMERICA'S CENTRAL PROBLEM: CAPITAL SCARCITY

American economists generally believe that higher consumer spending stimulates investment spending. But if it takes a growing share of GDP, as it has done in the United States during the past few years, this

inevitably decreases the real resources that are available for capital investment. For the old economists of all schools of thought, it was a truism that the sustainable rate of capital formation is determined by the rate of national saving, and these have collapsed in the United States.

Friedrich Hayek and some of his contemporaries called it the phenomenon of capital scarcity. In essence, it says that capital formation must shrink whenever consumption increases its share of GDP, just as booming investment inherently curtails the share of consumption. Hayek called it the *"central point of the true explanation of economic crises."*

He continues: *"At the same time it is no doubt the one point that rouses most objections and appears most improbable to the lay mind… That the apparent abundance of capital goods should be a symptom of a shortage of capital, and that the cause of this should be not an insufficient but an excessive demand for consumers' goods, is apparently more than a theoretically untrained mind is readily persuaded to accept."*

For us, this is the true clue to America's present structural woes. For the consensus, the existing excess capacities in the United States are compelling proof of past excessive capital investment. In this view, it therefore needs more consumer spending to restimulate investment spending.

In contrast, this concept of capital scarcity says that the excess capacities have the exact opposite cause. As consumption soared as a share of GDP, this essentially implied a decreasing share of investment. In other words, the investment goods industries lost demand in favor of the consumption sector. Putting it differently, the consumption boom crowded out capital investment. The spectacular counterpart was the collapse of saving. When one GDP component overexpands, another one must shrink.

This shift in the allocation and use of available real resources is implemented through the price mechanism, that is, through changes in the relative prices. Prices in the shrinking sector of the economy fall in relation to the prices of the expanding sector. Typically, prices of capital equipment in the United States have been much weaker than those of consumer goods for years.

Recessions are notoriously periods in which consumers and businesses correct their spending excesses built up during the earlier boom. To resurrect sustainable economic growth, it requires the return to the desired and sustainable pattern of consumption, saving and investment.

But such necessary adjustments are not taking place this time, neither in the macro aggregates nor in the micro conditions. Instead of restraining the protracted excess in consumer spending, the Fed's looser and looser monetary policy has fostered new, dangerous bubbles sustaining the same ill-structured economic and financial development as in the past years. Nor does the development on the corporate level give any hope for a meaningful and sustained improvement in profits.

ELUSIVE RECOVERY

The current consensus is that U.S. real GDP growth — after a yearlong "soft spot" — will experience a revival to a 3.5–4% pace in this year's second half after 1.4% in the first half, and that a similar, if not stronger, pace of expansion will be sustained in 2004. A common perception is that the economy is improving.

During the past several months, we have insisted that these recovery forecasts lack any basis in the hard economic data. The most recent data give us no cause to change our mind. Even more important for us is the observation that those maladjustments in the economy that we regard as the decisive impediments to a sustainable revival, such as poor profits, weak balance sheets and others, still fail to show meaningful improvement.

CONCLUSION

The best that we can see for the U.S. economy over the next six months and in 2004 is more of the same lackluster growth as in the past 16 months, perhaps with statistical spurts. More pronounced weakness appears more probable to us.

Banks, dealers and hedge funds have suffered big losses on the huge bond positions they had built up

through the carry trade in the expectation of a further rate decline. Yields of 10-year Treasuries have risen more than 1 percentage point, implying a loss on the capital value of around 8%.

Desperation to make profits against the background of record-low interest rates and business profits has led to widespread, reckless financial behavior of lenders and investors. It has buoyed the markets, but is increasing the risks of financial crisis. There is little or no spillover into the real economy.

False optimism about U.S. economic growth has temporarily buoyed the dollar. New disappointment will send it sliding again. Fundamentally, the bullish trend of the euro remains in place. Not only is the Eurozone's bilateral current account surplus still rising but capital flows have also turned in its favor.

The consensus view is still not bearish enough on the dollar. In any case, stronger U.S. growth does not necessarily translate into a stronger U.S. currency. The key condition is capital inflows in excess of the monstrous U.S. current-account deficit, and that is far and away impossible.

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Dr. Kurt Richebächer, Editor
Published by Agora Financial, LLC.
Jeanne Smith, Publisher
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